

Boston University School of Law

Scholarly Commons at Boston University School of Law

Faculty Scholarship

2008

A Theory of Wealth and Punitive Damages

Keith Hylton

Boston Univeristy School of Law

Follow this and additional works at: https://scholarship.law.bu.edu/faculty_scholarship



Part of the [Law Commons](#)

Recommended Citation

Keith Hylton, *A Theory of Wealth and Punitive Damages*, 17 Widener Law Journal 927 (2008).

Available at: https://scholarship.law.bu.edu/faculty_scholarship/664

This Article is brought to you for free and open access by Scholarly Commons at Boston University School of Law. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarly Commons at Boston University School of Law. For more information, please contact lawlessa@bu.edu.



BOSTON UNIVERSITY SCHOOL OF LAW

WORKING PAPER SERIES, LAW AND ECONOMICS
WORKING PAPER No. 08-09



A THEORY OF WEALTH AND PUNITIVE DAMAGES

KEITH N. HYLTON

A Theory of Wealth and Punitive Damages

Keith N. Hylton*

forthcoming, Crimtorts Symposium, Widener Law Journal

Abstract: One recurring problem in the punitive damages case law is the degree to which the wealth of the defendant should matter in the determination of a punitive award. Intuition suggests that the wealthy should pay more than the non-wealthy. On the other hand, the view has been expressed that wealth should not play a role in the determination of a punitive award. I will use examples to develop several arguments. The claim that wealth is seldom relevant to the determination of a punitive award is unsupportable. The key proposition advanced in this paper is that the defendant's wealth is relevant when either the victim's loss or the defendant's gain from wrongdoing is unobservable and correlated with the defendant's wealth. Since the victim's loss typically will be observable, wealth will tend to be a relevant factor when optimal deterrence requires elimination of the defendant's gain.

* Professor of Law and Paul J. Liacos Scholar, Boston University, knhylton@bu.edu. I thank participants in the Widener Law School Crimtorts symposium for helpful comments.

Introduction

One recurring problem in the punitive damages case law is the degree to which the wealth of the defendant should matter in the determination of a punitive award.¹ In other words, given some reprehensible act that would merit a punitive damages award under the law, should the amount of the award vary with the defendant's wealth? Should deep pocket defendants pay more than those with shallow pockets?

It may seem intuitive that wealthy defendants should pay more than the non-wealthy. A six-figure punitive judgment against a multi-billionaire would have the same deterrent impact as a parking ticket to the average person.² And it seems intuitively undesirable to have a class of potential defendants who view punitive judgments as most of us view parking tickets – that is, as a nuisance fine that we have to pay occasionally but do not view as so threatening as to prevent us from committing the violation that generated the fine. I think we all share the view that the acts that typically result in punitive judgments in court should be completely deterred; and if we were to discover that among a class of fabulously wealthy, punitive judgments were viewed as nothing more than nuisance fines, leaving it to their discretion or caprice whether to comply with the law, we would consider it a serious failure of the legal system.

On the other hand, the view has been expressed that wealth should not play a significant role in the determination of a punitive judgment.³ If we limit the role of punitive judgments to internalizing the social costs of offensive conduct, then an economically rigorous argument can be offered for ignoring the wealth of the defendant. Under this view, if the defendant imposes a loss of \$100 on a plaintiff and an additional loss of \$200 on society, the compensatory award should be set at \$100 and the punitive award at \$200. In this approach, the compensatory and the punitive award, which together internalize the full social costs of the defendant's conduct, are both independent of the wealth of the defendant.⁴ The multi-billionaire and the pauper pay the same punitive judgment.

The argument against taking wealth into account can be put on a broader platform. Suppose an interest in a certain sum of money is what drives the defendant to commit his reprehensible acts. If the defendant is driven by a desire to obtain a definable profit or to

¹ In *State Farm v. Campbell*, 538 U.S. 408, 427 (2003), the Supreme Court said that “[t]he wealth of a defendant cannot justify an otherwise unconstitutional punitive damages award.” Since it is obvious that no court can legally “justify” or affirm an unconstitutional award, the Court’s statement could be understood as a direction to lower courts that they should not use wealth as the primary basis for determining a punitive award.

² Moreover, the marginal utility of a dollar of wealth probably falls as wealth increases. If punishment is designed to inflict a certain loss in utility on the actor, it follows that the wealthy actor should be assessed a larger monetary penalty than the non-wealthy actor. Although this is a somewhat technical form of the argument, I think it is still consistent with common intuition.

³ Kenneth S. Abraham & John C. Jeffries Jr., *Punitive Damages and the Rule of Law: the Role of Defendant’s Wealth*, 18 *Journal of Legal Studies* 415 (1989); Amicus Curiae Brief of A. Mitchell Polinsky, Steven Shavell, and the Cato Institute in Support of Petitioner, *Philip Morris USA, Williams*, 05-1256, 2007 U.S. LEXIS 1332 (2007) (No. 05-1256).

⁴ This example is based on the argument of Abraham & Jeffries, *supra* note 2.

avoid a definable cost, the punitive judgment can be set a level that prevents the defendant from obtaining that profit or avoiding that cost. As long as the profit or cost can be defined independently of the defendant's wealth, there should not be a need to consider or even to know the defendant's wealth when determining the proper punitive award.⁵

These are straightforward arguments, but they take us into a vast literature on the theory of damages,⁶ a literature that consists of instrumentalist and moral arguments.⁷ I will not attempt to review the literature here. My approach is thoroughly instrumentalist. Rather than leading with theory, I prefer to employ straightforward arguments and examples. This may seem to be ad hoc and casuistic, but it identifies and illustrates the limits of sweeping theoretical claims about the relevance of wealth in punishment.

I will use simple examples to develop several arguments. First, the claim that the wealth of the defendant is never relevant, or seldom relevant, in the determination of a punitive judgment is unsupportable. To be sure, one can conjure examples in which wealth is not relevant. But as a general proposition, wealth is relevant in the determination of a punitive award. Second, the more interesting questions involve when and under what conditions will wealth be relevant in determining a punitive judgment. Not a great deal of attention has been given to this question. I hope to at least set out the outlines here of a theory of wealth and damages.

The key proposition advanced in this paper is that the wealth of the defendant is relevant in the determination of a punitive award when either the victim's loss or the defendant's gain from wrongdoing is unobservable and correlated with the defendant's wealth. Since the victim's loss typically will be observable, wealth will tend to be a relevant factor when optimal deterrence requires the elimination of the defendant's gain from wrongdoing.

Some Examples

⁵ Polinsky & Shavell brief, *supra* note 2, at 7-8, arguing that wealth should not play a role if the injurer acts with a monetary (in contrast to non-monetary) interest in mind. I focus on instrumentalist arguments in the text of this paper. The moral arguments for punishment would appear to open more questions about the role of wealth in the determination of a punitive award. If punitive damages should be levied only as retribution for some serious moral failure, then it is not clear why wealth should matter at all to punishment. The moral failure is determined by the act, not by the actor's wealth. See, e.g., Abraham & Jeffries, *supra* note 2, at 422-423.

⁶ See, e.g., Keith N. Hylton, Punitive Damages and the Economic Theory of Penalties, 87 *Georgetown Law Journal* 421 (1998); A. Mitchell Polinsky & Steven Shavell, Punitive Damages: An Economic Analysis, 111 *Harvard Law Review* 869 (1998).

⁷ For the instrumentalist literature, see, e.g., Polinsky & Shavell, Hylton, *supra* note 5; Jennifer H. Arlen, Should Defendants' Wealth Matter? 21 *Journal of Legal Studies* 413 (1992); A. Mitchell Polinsky & Steven Shavell, A Note on Optimal Fines When Wealth Varies Among Individuals, 81 *American Economic Review* 618 (1991); David D. Friedman, Reflections on Optimal Punishment or Should the Rich Pay Higher Fines? *Research in Law and Economics* (1981). For the moral literature on punitive damages, see, e.g., Benjamin C. Zipursky, A Theory of Punitive Damages, 84 *Tex. L. Rev.* 105 (2005); Anthony J. Sebok, Punitive Damages: From Myth to Theory, 92 *Iowa Law Review* 957 (2007).

I will start with a set of simple examples to flesh out the issues raised by variations in the defendant's wealth in the damages context. I will use the terms "injurer" and "defendant" interchangeably, and the same with the terms "victim" and "plaintiff".

First, consider the case in which the injurer (defendant) deliberately destroys the flower garden of the victim (plaintiff), solely to harvest a spiteful pleasure.⁸ To provide a concrete visual description, suppose the injurer drives his sport utility vehicle over the victim's extensive and painstakingly-developed flower garden several times in order to make sure that he has destroyed it completely. Should the defendant's wealth matter in this case? It has been suggested that the injurer's wealth should matter in this case, because a wealthy actor would not be deterred by a small fine.⁹

Second, suppose the injurer commits the same wrong, but entirely by accident. Unaware of the location of the victim's flower garden, the injurer drives his sport utility vehicle over it several times as he tries to make room for a group of bikers passing through his neighborhood. Should the injurer's wealth matter in this case, and should this case be treated differently from the first one?

Third, suppose the injurer walks over to the victim's property and steals several of the most impressive flowers from the victim's garden, and brings the flowers home, to put them in pots where he can see them up close. He destroys part of the victim's garden, but not for a spiteful pleasure this time. He gains nothing from knowing that he has injured the victim. He wants only to enjoy the flowers from a closer perspective. Should this case be treated differently from the first case?

Fourth, suppose the injurer steals flowers from the victim's garden in order to sell them to a third party. He discovers that the flowers are valuable to the third party and seeks to make a substantial profit from selling them.

Fifth, suppose the invader (defendant) parks his car in the garages of victims. He owns a valuable car and he does not want it to be scratched or damaged by the weather. The invader could have parked his car in a commercial garage for a moderate fee.

Should the wealth of the defendant matter in the determination of a punitive judgment, if there is a punitive judgment, in any of these cases?

After examining these cases I will consider the case of corporate actors. One might argue that the wealth of a corporate actor should matter less in the punishment determination than the case of an individual actor.¹⁰ Suppose, for example, the corporation steals an asset from a victim. How should the defendant's wealth be measured, or in what sense is it relevant, in the case of a corporate actor? Does the fact that the actor is a corporation require any modifications of the arguments developed for the case of individuals?

⁸ This example is taken from the Polinsky & Shavell amicus brief, *supra* note 2, at 7.

⁹ *Id.*

¹⁰ Abraham & Jeffries, *supra* note 2, at 421-423; Polinsky & Shavell amicus brief, *supra* note 2, at 8.

Economic Principles of Damage Awards and Implications for Wealth

In order to decide whether wealth is relevant in the determination of a punitive award, we first have to determine the goal or purpose of the punitive award. The literature has so far identified two general goals for punitive awards.

One goal is to *internalize the losses* borne by society as a result of the defendant's conduct.¹¹ If the defendant imposes a loss of \$100 on the plaintiff and an additional loss of \$200 on society the internalization goal would require a compensatory award of \$100 and a punitive judgment of \$200.

An alternative goal for the punitive judgment is to *eliminate the gain* from the defendant's conduct. Thus, if the defendant imposes a loss of \$100 on the plaintiff and at the same time gains \$500 from his conduct, the gain elimination approach would require a compensatory award of \$100 and a punitive award of at least \$400. With a compensatory award of \$100 and a punitive award of \$400, the defendant would pay a judgment of \$500, which would be just sufficient to eliminate the gain from his conduct.

The two goals are really antecedent to larger goals. For both goals, the ultimate aim is to minimize overall social costs or, equivalently, to maximize social welfare. In the setting in which internalization is the goal, overall social costs are minimized by creating incentives for efficient precaution. If the injurer's conduct imposes a loss on society of \$300, overall social costs will be minimized if we can set up a system that induces the injurer to incur precaution costs as long as they total to less than \$300. The internalization approach avoids creating incentives for the injurer to spend \$400 in order to avoid imposing a cost on society of \$300. The internalization approach does not aim to eliminate the injurer's activity altogether, but to find the efficient scale. This is a sensible approach when the injurer's activity generates benefits to society that exceed its social costs.

For example, suppose the injurer's activity is driving. Suppose that during a given week of driving, the injurer gains \$500 per mile over the first 100 miles and \$200 per mile from the next 100 miles. At the same time, the injurer's activity imposes costs on society. The expected cost to immediate accident victims is \$100 per mile. There is also a pollution cost of \$200 per mile. It follows that the full cost of the injurer's activity is \$300 per mile. Including a punitive judgment to internalize pollution costs would lead the actor to maintain his activity as 100 miles per week.¹² This approach minimizes overall social costs.

¹¹ Catherine M. Sharkey, Punitive Damages as Societal Damages, 113 Yale Law Journal 347 (2003); see also Polinsky & Shavell, *supra* note 6; Hylton, *supra* note 6.

¹² If the injurer increased his activity to 110 miles per week, he would enjoy a gain on the margin of \$200 per mile for the last 10 miles, but would also suffer a loss of \$300 for those miles. His net gain over the last 10 miles would be -\$100. The injurer would improve his welfare by reducing his activity to 100 miles per week or less.

In the case of gain elimination, the intermediate aim of the penalty is to *completely deter* the defendant's activity – to drive its frequency to zero rather than to some optimal level. In the driving example just considered, if we impose damages sufficient to eliminate the \$500 gain to the injurer, that would eliminate the injurer's activity altogether. The goal of the gain-elimination penalty is to maximize welfare, just like the internalization penalty. But the gain-eliminating penalty maximizes welfare by driving the injurer's activity to zero.

Now, one could get complete deterrence through an internalization-based system. Suppose, in the driving example just considered, the pollution cost of the injurer's activity is \$500 per mile. If the punitive award is structured to internalize the \$500 per mile pollution cost, this would drive up the defendant's per mile cost to \$600 (the sum of compensation to accident victims and pollution victims). Facing a per mile cost of \$600 and a per mile gain of \$500, the potential defendant would forgo the activity of driving (i.e., set his activity level at zero).

Given that internalization will sometimes accomplish the goal of complete deterrence, one might argue, as Gary Becker did many years ago,¹³ that we can simply do without gain-eliminating penalties. We can pursue the goal of cost-internalization exclusively, and let that goal generate complete deterrence when that is implicated by the realized costs and benefits.

The problem with this solution was first recognized in the Calabresi-Melamed article on property rules and liability rules.¹⁴ It is true that the cost-internalization approach will eliminate gains and accomplish the complete deterrence goal whenever (external) costs exceed (internal) gains. But there are instances in which the cost-internalization approach fails to generate the socially optimal outcome.

The first such instance is when the potential injurer interacts with the potential victim in a *low transaction cost setting*. In this instance, the potential injurer can bargain with the potential victim before taking an action that imposes a loss on the potential victim. Since market transactions are cheaper than litigation, and more accurate in allocating resources efficiently, society should have a strong preference for the potential injurer to bargain with the potential victim rather than acting in an injurious manner and dealing with a lawsuit later. For example, rather than take the flowers from his neighbor's garden and respond to some legal proceeding later, the injurer can simply offer a price to the victim and see whether a deal can be struck between them.

When transaction costs are low, society prefers actors to use the market. Overall social welfare is maximized through the use of market transactions *ex ante* (before the transfer of an entitlement) rather than *ex post* litigation.

¹³ Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968).

¹⁴ Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harvard Law Review 1089 (1972).

Given this, gain-eliminating rather than cost-internalizing penalties should be used whenever injurers bypass the market in low transaction cost settings. If the injurer takes valuable flowers from the victim, the penalty should be set at a level that eliminates the injurer's gain rather than internalizing the victim's loss. The reason is that if the penalty is designed merely to internalize the victim's loss, some injurers may find it profitable to steal flowers. For example, if the injurer gets a gain of \$1000 from stealing flowers, and the victim loses flowers that are worth only \$100 to him, a system of cost-internalizing penalties will fail to encourage the potential injurers to use the market.

The second instance in which the cost-internalization approach may fail is when the potential injurer's activity is, from society's perspective, simply not worth the candle. There are some activities that impose large costs on society and the benefits are clearly insufficient to justify the costs. For example, suppose the injurer enjoys playing with loaded guns on crowded buses. Or suppose the injurer enjoys speeding in the opposite direction on crowded highways. The eventual compensatory damage awards may be substantial and sufficient to eliminate any gains enjoyed by the injurer. But why wait for this level of internalization to occur when it is obvious to everyone that the costs of the defendant's activity far outweigh any objective measurement of the benefits? The injurer's activity should be completely deterred, and that should be the goal of any punitive judgment.

The philosophically-oriented might argue that this second category should not be recognized because of the possible existence of "utility monsters", people who gain near infinite utility from engaging in conduct that few of us would consider especially enjoyable.¹⁵ According to this view, if the potential defendant who plays with guns on crowded buses enjoys a near infinite level of utility, his conduct should be not completely deterred. But law has to work in the real world, and it may be nearly infinitely costly to distinguish utility monsters from ordinary people. An administratively reasonable system would balance the costs of false convictions against the costs of false acquittals. A judgment to apply the complete deterrence approach to whole swaths of activity for which the costs are both great and far in excess of the estimated benefits is entirely rational.

One can evaluate the role of wealth in a system of punitive damages in light of the foregoing theory. Under the cost internalization approach, the optimal punitive damage award will be determined by external costs (victims' losses). The optimal punitive award will be a function of the defendant's wealth only when the external costs are a function of the injurer's wealth. It follows that where the external costs are directly observable and measurable, there should be little need to use information on the defendant's wealth. Information on the defendant's wealth becomes relevant to the determination of a punitive award only when the external costs are not observable and wealth can be used as a proxy or to help estimate external costs. Since in most cases the external costs will be directly observable, information on the defendant's wealth will not be necessary: the billionaire and the pauper will pay the same amount of damages.

¹⁵ Robert Nozick, *Anarchy, State, and Utopia* 37 (1974).

Under the gain-elimination approach, the optimal punitive award will be determined by the defendant's gain from wrongdoing – the minimum award will be equal to the gain. Where the gain is directly observable and measurable, it will not be necessary to have information on the defendant's wealth. Where the gain is not observable and is correlated with the defendant's wealth, information on wealth will be useful in determining the optimal punitive award.

The most important difference between the cost-internalization and gain-elimination approaches is that the "parameter of interest" is more likely to be unobservable under the gain-elimination approach. The parameter of interest under the gain elimination approach is the defendant's gain. In many cases, the gain will be unobservable and also correlated with the defendant's wealth. For example, if the defendant takes an entitlement of the victim that he values for consumption purposes, his valuation or willingness-to-pay for the entitlement may be affected by his wealth. In those cases the defendant's wealth will be relevant in the determination of an optimal punitive damages award.

This suggests a general proposition:

Where the parameter of interest in the determination of an optimal punitive award, external cost or internal gain, is unobservable and correlated with the defendant's wealth, the optimal punitive award will be a function of the defendant's wealth.

Knowing that the optimal punitive award for deterrence purposes is a function of the defendant's wealth does not tell us whether it is an increasing or decreasing function. Common intuition would suggest that it is an increasing function. But common intuition may be incorrect.

If the optimal penalty is one that strips defendant's gains, then wealth is relevant to the determination of the penalty if the gains are unobservable and correlated with wealth. However, the correlation could be negative or positive. For example, suppose the injurer takes some object from the victim. If the object of desire to the defendant is an *inferior good*, in the sense that the defendant's valuation of it declines as his wealth increases, then the correlation between wealth and gain will be negative. On the other hand, if the object of desire is a *normal good*, in the sense that the defendant's valuation of it increases as his wealth increase, the correlation between wealth and gain will be positive.

One can offer a general statement for the case of a gain eliminating penalty. Let us define the outcome or event that generates the defendant's gain as the desideratum of the defendant's act. For example, if the injurer steals the victim's flowers in order to enjoy them up close, the outcome in which the injurer enjoys the stolen flowers at home is the desideratum of his act. Or, if the injurer destroys the victim's flowers, the outcome in which he has destroyed the flowers is the desideratum of his act. As a general rule, *if the defendant's valuation of the desideratum of his act is unobservable and increasing (decreasing) in his wealth, the optimal punitive judgment will be increasing (decreasing) in the defendant's wealth.*

In the remainder I will return to the examples presented earlier.

Applications

Example 1

Recall that in the first example the injurer deliberately destroys a garden that belongs to the victim, for no other reason than spiteful pleasure. Common intuition would hold that wealth should be relevant in the determination of a punitive damages award in this case, and that the punitive award should increase in the defendant's wealth.¹⁶

The foregoing analysis suggests that this case is more complicated than the standard intuitive approach. First, it is not absolutely clear that wealth should play a role in this example. The proper penalty should be determined by examining the injurer's gain from his act: the difference between the payoffs when the injurer destroys the victim's garden and when he refrains from doing so. If the payoff spread is independent of wealth, then it would be incorrect to conclude that wealth should be a factor in determining the punitive award.

In order to examine the payoff spread, we need to determine the injurer's gain from destroying the flowers. If the penalty is at least as large as that gain, then it will be sufficient to deter the injurer. The key question is whether the penalty should vary with the injurer's wealth.

The reason wealth is likely to be a factor in the optimal punitive award in this example is that we cannot observe the injurer's gain, and that gain is likely to be correlated with the injurer's wealth. His gain is equal to the maximum he would be willing to pay to impose this particular loss – destruction of the garden – on the victim. There are no available objective signals of the injurer's gain in this case. However, it is highly plausible that the injurer's gain is correlated with his wealth.

If the spiteful pleasure the injurer enjoys from knowing that the victim's garden has been destroyed is a normal good, then the injurer will be willing to pay more for the destruction as his wealth increases. The optimal punitive award will therefore be positively correlated with the defendant's wealth. If the injurer's valuation of the spiteful pleasure from destruction is an inferior good, then the optimal punitive award will be negatively correlated with the defendant's wealth.

In general, we will be unable to tell whether the injurer's spiteful pleasure from destruction is a normal good or an inferior good. At some level of wealth, the pleasure from destruction probably becomes an inferior good. If we consider the reputational effect of information spreading about the injurer's activity as a potential cost to the injurer, then it is possible that the pleasure from destruction starts to fall with wealth beyond a certain level. As an injurer's increasing wealth pushes him into the class of

¹⁶ See, e.g., Polinsky & Shavell amicus brief, *supra* note 2, at 7.

famous and fabulously wealthy – famous because of wealth – he may experience a decline in his valuation of the spiteful pleasure of destruction. His willingness to pay for that spiteful pleasure could decline with his wealth as he crosses into the class of the famous and wealthy. To make this argument clearer, suppose the valuation the injurer attaches to destruction is \$10,000 when his wealth level is \$5 million, and \$12,000 when his wealth level is \$100 million. On the other hand, the reputational effect of his bad conduct is \$5,000 when his wealth is \$5 million, and \$10,000 when his wealth is \$100 million. The injurer's net gain from his destruction is therefore \$5,000 when his wealth level is \$5 million and \$2,000 when his wealth level is \$100 million. Since the injurer's valuation of the destructive act falls as his wealth increases, there would be no need for deterrence purposes to impose a larger penalty on the injurer when his wealth level is \$100 million than when his wealth level is \$5 million.

The previous example treats reputation as a factor, like a price, that alters the injurer's incentives. However, one could offer a simpler explanation for the inferiority of the injurer's valuation of destruction. One could argue that as the injurer's wealth increases, he finds that he prefers to spend it on luxury goods rather than on destruction.

Still, in the absence of objective measures of the correlation between wealth and the spiteful pleasure from destruction, the most plausible assumption is that it is a normal good like most others. In the absence of any reason to assume that the injurer's desideratum is an inferior good, the optimal punitive award in the case of destroying the neighbor's flower garden should increase with wealth.

Example 2

In this example the injurer destroys the victim's garden by accident, as he maneuvers his car in order to make room for a passing group of bicycle riders. The injurer's activity is entirely normal and one that society has no interest in completely deterring. Given this, the goal of any damage award should be to internalize the losses of victims rather than to completely deter the injurer's activity.

The victim's loss might be positively correlated with the injurer's wealth. The weight of the injurer's car may be a function of his wealth – as the injurer's wealth increases he may be inclined to buy a more expensive and heavier car. A heavier car results in more damage to the victim's flower garden.

However, the usefulness of information on the defendant's wealth should be quite limited in this scenario. The victim's losses usually will be directly measurable. If they are not directly measurable, they might be estimated by information on the weight of the car. The defendant's wealth becomes relevant in this scenario only if the direct losses to the victim are unobservable (there is no way to tell how extensive the garden was before the accident), and other signals of the degree of harm (e.g., weight of the car) are also unobservable. Under these conditions, wealth might be useful as a proxy for the victim's loss. But this would be an unusual case. And even if these conditions were realized, it is

unlikely that a court would opt to use such an imprecise proxy as wealth in order to estimate the loss suffered by the victim.

One might argue that this scenario is unhelpful to the analysis because there really is no case for an award that goes beyond the compensatory level. One could modify the example to include some additional external cost suffered by society. For example, suppose the injurer frequently experiences the same accident with other victims, and only half of them sue for the loss suffered. If the loss suffered is the same in each case, a proper damage award on deterrence grounds would internalize the losses suffered by society. This would require a multiplier of 2 in every lawsuit brought by a victim for accidental destruction of a garden.¹⁷ Half of the damage judgment would consist of the compensatory portion and the other half would consist of the punitive portion.

In this modified scenario, wealth will again be correlated with the external cost of the injurer's activity. If the injurer's wealth is correlated with the weight of his car, the total external cost of the defendant's activity will be correlated with his wealth. But it would be an unlikely setting in which the court could not find a direct measure of the external losses.

These scenarios suggest that when loss internalization is the proper goal for deterrence purposes, the wealth of the injurer usually will not be relevant to the determination of a damage award. Direct measures of the social loss generally will be available. Where they are not available, there will be more precise proxies available than the wealth of the injurer. Wealth may be positively correlated to the proper award for deterrence purposes. But it will seldom if ever be useful in the calculation of an award.

Example 3

Now suppose the injurer steals the victim's flowers to look at them up close in his own home. This is a version of the first example. Instead of hurting the victim in order to harvest a spiteful pleasure, the injurer takes from the victim in order to harvest the pleasure of enjoying the stolen property. The acts are different, but on utilitarian grounds the first example and this example are similar.

The pleasure of enjoying flowers is likely to be a normal good, and there is plenty of market data to suggest that it is. The demand for flowers increases with income.¹⁸ The wealthy obviously have a greater demand to use them as decorations or as gifts. In

¹⁷ Since only half of the victims bring suit, the expected liability following any particular violation would be half of the actual loss suffered by the victim. In order to internalize the full loss suffered by the victim, it would be necessary to apply a multiplier of 2 to the victim's compensatory damage award. For an argument that punitive damages should be based on the multiplier principle, see Polinsky & Shavell, Punitive Damages, *supra* note 6. For a critical view of the multiplier principle, in the context of damages, see Richard Craswell, Deterrence and Damages: The Multiplier Principle and its Alternatives, 97 Michigan Law Review 2185 (1999).

¹⁸ Common intuition would suggest this, since flowers are purchased with discretionary income. For validation, see, e.g., <http://www.smartcompany.com.au/Premium-Articles/Industry-Trends/20080214-Flower-retailing-industry-trends.html>.

comparison to the first example, in which the injurer destroys the victim's flowers, this case is more likely to be one in which the optimal punitive award is positively correlated with wealth.

The link between wealth and the punitive award could be defined further in this case. One could use the market data available on income and flower purchases to estimate the extent to which willingness to pay for flowers increases with income, and perhaps wealth as well. Suppose an econometric study showed that the willingness to pay for flowers increases \$1 for every \$1000 increment in wealth beyond the average level. A court could use this information to schedule punitive awards based on wealth. If the defendant's wealth level is \$1 million above the average, the punitive award should be increased by \$1000 above the level for a defendant of average wealth.

Obviously, this example is infected with the same imprecision that is observed in the first example. One cannot use wealth to arrive at a precise estimate of the injurer's gain – and finding a precise estimate of gain would enable a court to accurately set the punitive award at a level that eliminates the gain. But in this case, unlike the first example, there is no direct measure of the gain, nor is there any single quantitative proxy that clearly would be superior to wealth. One alternative to using wealth as a single quantitative proxy would be to use a hedonic regression equation to estimate the injurer's gain in the particular case before the court. But this might suffer from imprecision as well, given the unlikelihood of finding a useful sample, and the administrative costs could be prohibitive. The penalty designer is therefore forced, as practical matter, to choose between using wealth as a proxy for gain and forgoing any effort to determine a gain-eliminating judgment. As long as the injurer's conduct is of the type that society should wish to see completely deterred, it appears preferable to use wealth as an index of gain.

Example 4

The final variation on stealing flowers is the case of stealing them to sell them to a third party. Suppose the third party is willing to pay \$1000 for each flower, because the third party has an unusual and special interest in the flowers. The injurer steals 30 flowers from the victim.

The injurer's gain is locked in at \$30,000. In this case, a penalty of at least \$30,000 will be sufficient to deter the defendant's conduct. Suppose the plaintiff loses \$100 as a result of the theft – because the plaintiff would have never discovered the existence of the third party on his own. The optimal judgment is a \$100 compensatory award and a punitive judgment of at least \$29,900.

In this example, the wealth of the injurer should play no role in the determination of the punitive award. The reason is that the gain to the injurer is determined by an objective exogenously determined price.

The general statement that follows from this example is that whenever the gain to the injurer from an act that should be completely deterred is determined by an exogenously

determined monetary sum, there is no reason to use the injurer's wealth in the determination of a punitive judgment.

The simplicity of this example is easily destroyed by altering it to assume that the injurer enjoys the act of stealing or the knowledge that the flowers he sells are stolen. This modification would return us to the issues confronted in the first example.

Example 5

Now the invader parks his car in the neighbors' garages. This is unlike the first and third examples, because there is clearly a monetary motivation behind the invader's conduct. However, this is also distinguishable from the fourth example because we cannot easily fix a price on the invader's gain.

One could try to fix a price for the invader's gain by looking at the charges of commercial parking garages. The argument would run as follows: since the invader avoids the charges of the commercial garages, his gain from stealing neighbors' property is equal to the commercial parking fee avoided. Thus, if the commercial garages charge \$25 a day, the invader's gain is \$25 for every invasion.

But this argument is incorrect, because the invader's gain is really equal to the maximum that he is willing to pay to protect his car. If the invader is willing to pay \$50 per day to protect his car, then his gain is \$50 for every invasion. Of course, invading a neighbor's garage may be costly in some respects. The neighbor might retaliate violently. The net gain to the invader is the gain he enjoys from protecting his car, less the expected cost of retaliation from the neighbor.

Is the wealth of the invader relevant in the determination of a punitive award in this case? Probably not; the injurer's gain is determined solely by the market value of the asset he seeks to protect. The injurer would have little to reason to fix a subjective valuation in excess of the market value of the asset. He would have little reason, in general, to spend \$60,000 to protect an asset that is worth \$50,000.

The message from this example is that when the gain to the injurer is determined by the value of an asset, and that value is determined by the market, the injurer's wealth should not be relevant to the determination of a punitive judgment.

Things become more complicated if the invader experiences a spiteful pleasure from using the garages of neighbors, as in the first example. Wealth could be relevant to the determination of the punitive award in that case.

Corporations as Injurers

To this point I have considered the role of wealth, in the determination of a punitive judgment, in the context of individual versus individual lawsuits. What if the defendant is a corporation? It has been suggested that wealth should play no role in the

determination of a punitive judgment against a corporation. The reason is that a corporation will be rationally motivated by the incremental monetary benefits and costs of its actions, and those benefits and costs should be independent of the wealth of the corporation.

One preliminary issue that arises is what it means to take the wealth of the corporation into account in determining a punitive judgment. One could measure the wealth of a corporation in a number of ways – e.g., by expenditures, by revenue, or by stock market capitalization. A firm could have a substantial revenue and a relatively small stock market capitalization, and vice versa, since the former is a reflection of current income and the latter is based on the expected stream of future profits.

The foregoing analysis of individuals applies with only minor modifications to corporations. The most important modification concerns motives. It seems fair to assume that corporations are rationally motivated by the monetary benefits and costs of their proposed actions, and not by the desire to experience a spiteful pleasure in injuring someone. In analyzing the corporation, I will assume that it does not act out of the non-economic motivations that sometimes direct the conduct of individuals. A scenario in which the injurer destroys the property of the victim in order to derive pleasure from inflicting a loss on the victim will not be considered in this discussion as a plausible one for a corporation.

Although corporations are motivated by rational economic interests, this does not mean that they never engage in the type of conduct that should be completely deterred. A rational, economically-motivated actor, such as a corporation, may choose to steal the property of another. The proper remedy for theft is a gain-stripping penalty that completely deters the activity.

Assume, then, that a corporation steals the property of some victim – perhaps an individual or another corporation. The optimal penalty would strip the gains to the corporation from the theft of the property. The gain can be measured directly by the corporation's valuation, or willingness-to-pay, for the stolen property.

The corporation's valuation of a parcel of property will be based on the expected stream of profits that can be attributed to ownership of the property. Suppose the property is a tract of land containing oil reserves.¹⁹ Suppose the oil reserves, under the management of the corporation, are expected to generate a stream of profits of \$100,000 every year. If the interest rate is 5%, the net present value of the profit stream will be \$2 million. Thus, the corporation's gain from stealing the property will be \$2 million. The gain stripping penalty should be at least \$2 million.

As this example suggests, the gain to the corporation in a routine taking will be determined by the profitability of the taking. The profitability of the taking rather than corporate wealth is the key determinant of the optimal punitive judgment. As long as the

¹⁹ For a real case involving theft of land containing oil reserves, see *TXO Production Corp. v. Alliance Resources*, 509 U.S. 443 (1993).

profits attributable to the corporation's theft can be observed and measured, there is no need to consider any measure of the corporation's wealth in the determination of an optimal punitive judgment.

This conclusion may seem to support the broad claim that wealth is irrelevant in the determination of a punitive judgment against a corporation. In a strict sense, this is true. The profitability of the corporation's act, not its wealth is the key determinant of the optimal punitive judgment. However, *some measure of corporate wealth may become relevant in the determination of a punitive judgment when the profitability of the corporation's act is not directly observable and the wealth measure is correlated with the profitability of the act.*

For example, suppose the corporation commits fraud against a targeted group of consumers accounting for ten percent of its revenue. Suppose also that the profits from the corporation's commission of fraud are difficult to determine, since it would require information on unit costs and transaction prices. A punitive judgment that strips the corporation of ten percent of its profit during the period of the fraud would appear to be a reasonable estimate of the gain eliminating penalty.

In this example, it might appear to some observers that a measure of the corporation's wealth – profits during the period of fraud – is being used to determine the appropriate punitive judgment; in other words, that the corporation is being punished on the basis of its wealth. Such an interpretation would be literally valid, but at the same time a misleading distortion of the process by which the punitive judgment was determined.

Admittedly, punitive judgments that tax a corporation on the basis of its profits are capable of being abused. Lawyers for plaintiffs will advocate for such awards on the ground that a "wealthy corporation" should not be allowed to get away with wrongdoing. However, there is also the potential for abuse from the defense side, as lawyers for defendants attempt to discredit such judgments as based on redistributive rather than punishment aims. However, the fact that lawyers might abuse the rules that permit such judgments is an argument for greater clarity with respect to the purposes of punitive awards within the courts, not for attempting to sever any connection between defendants' wealth and punitive judgments.

In addition to furthering the optimal deterrence goal in certain cases, punitive judgments that tax a corporation's profits serve desirable administrative ends. First, they spare the court the task of attempting to determine the profitability of the corporate defendant's acts on a microeconomic level. Even if the information necessary to determine profitability were available, it might require a team of econometricians to arrive at accurate estimates of profitability. Second, given that the information necessary to determine the profitability of the corporate defendant's acts is often not available, a punitive judgment that taxes the corporation's overall profits provides the corporation with an incentive to reveal the information on the specific gain directly to the court.

Viewed from an administrative perspective, the practice of taxing corporate profits can be seen as analogous to common law evidence rules such as *res ipsa loquitor*. Under the *res ipsa* doctrine, a court will infer negligence, unless the defendant can come to court with evidence disproving negligence. *Res ipsa* doctrine shifts the burden of proof from the plaintiff to the defendant under certain conditions, in part to provide the defendant with an incentive to bring evidence into court. The practice of taxing corporate profits is effectively a burden-shifting rule in the punitive damages context. The defendant can avoid having to pay a percentage of its overall profits if it comes to court with the evidence on the specific gains from the acts meriting punitive liability.

Under an ideal system, the corporation would choose to pay the tax declared by the court, or offer evidence that its specific gains were less than the amount of the tax. If the firm chose to pay the tax, then one could infer that its gains were not substantially less than the tax (and possibly greater). Of course, we are far from that ideal now, since corporate defendants are more likely, given the unstable nature of the law, to challenge an award that taxes profits as a redistributive taking, rather than come to court with evidence on their specific gains.

Conclusion

The claim that the wealth of the defendant is never relevant to the setting of an optimally-detering punitive damages award is invalid. There are instances in which wealth is not relevant, but there are also many instances in which information on wealth is quite useful in the determination of an optimal punitive award. In general, wealth is not a direct determinant of the size of an optimal award; there is no reason to think that the wealthy deserve harsher punishment *per se*. The factors that directly determine the size of an optimal award are the losses to society or the gain to the injurer from a reprehensible act. The defendant's wealth can be relevant to the determination of an award when these factors are unobservable and correlated with wealth.